

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF WASHINGTON

JOHN STAHL,

Plaintiff,

v.

UNITED STATES OF AMERICA,

Defendant.

No. CV-08-170-FVS

ORDER RE CROSS MOTIONS
FOR SUMMARY JUDGMENT

THIS MATTER comes before the Court based upon cross motions for summary judgment. The plaintiff is represented by Gary C. Randall, James J. Workland, and Eric J. Sachtjen. The defendant is represented by Jennifer D. Auchterlonie and W. Carl Hankla.¹

A.

John Stahl belongs to a religious corporation whose members live communally and hold their property in common. The corporation is not required to pay federal income tax. 26 U.S.C. § 501(d) (establishing an exemption for "[r]eligious . . . corporations . . . [that] . . . have a common treasury"). Instead, the corporation's members pay tax on its income. Members may reduce their tax liability by invoking deductions the corporation is entitled to take ("corporate-level" deductions). In addition, members may reduce their tax liability by

¹The Court has determined oral argument will not be helpful. Local Rule 7.1(h)(3).

1 invoking deductions they, as individuals, are entitled to take
2 ("individual-level" deductions). Mr. Stahl argues the religious
3 corporation to which he belongs may deduct from its gross income the
4 value of food and medical care it provided to him during tax years
5 1997, 1998, and 1999. Not only that, but also he argues he may deduct
6 from his gross income the value of meals he receives on the
7 corporation's premises for the corporation's convenience during those
8 same years.

9 **B.**

10 John Stahl paid his federal income taxes for tax years 1997,
11 1998, and 1999. Thereafter, he submitted timely claims for refund
12 with the Internal Revenue Service ("IRS"). The IRS denied his claims.
13 Consequently, he filed an action against the United States. He
14 alleges he overpaid his income taxes for the years in question, and
15 the IRS has improperly refused to refund his overpayments. He seeks
16 judgment against the United States in the amount of his alleged
17 overpayments, together with interest, attorney's fees, and costs. The
18 Court has jurisdiction over the subject matter of his action. 28
19 U.S.C. § 1346(a)(1); 26 U.S.C. § 7422.

20 Mr. Stahl is a founding member of the Stahl Hutterian Brethren
21 ("SHB"). The latter is nonprofit corporation that was organized in
22 order to enable its members to live in accordance with the tenets of
23 the Hutterite tradition. Hutterites are a branch of the Anabaptist
24 movement, which began in 16th century Europe. They live in colonies;
25 emphasizing communal life. The SHB is like an extended family. Its
26 core is composed of eight brothers, two sisters and their respective

1 spouses. Those ten couples have produced children. As a result, the
2 colony now numbers about 65 men, women, and children.

3 Like other Hutterite colonies, the SHB recognizes the spiritual
4 authority of the elders of the Hutterian church. Nevertheless, the
5 SHB is an independent corporation that exists under the laws of the
6 State of Washington. Active members of the SHB elect the
7 corporation's directors who, in turn, elect and supervise its
8 officers. Mr. Stahl is the SHB's current president. He is
9 accountable to the active members of the SHB for the colony's
10 spiritual and material well being.

11 A person transfers his property to the SHB when he becomes a
12 member. Members hold their property in common through the SHB as long
13 as they are members. However, a member may sever his relationship
14 with the SHB, or his fellow members may expel him. Should either
15 contingency occur, the person forfeits his interest in the SHB's
16 property. In the event he leaves the community, he takes the clothing
17 he's wearing, and that's about it.

18 The SHB's approach to property is illustrated, in part, by its
19 policy regarding credit cards. Individual members are not allowed to
20 maintain separate accounts with credit card companies. However, the
21 SHB has a corporate account. The president has issued copies of the
22 SHB card to approximately 20 members. A member may use the SHB credit
23 card to purchase an item in a store, but he must obtain the
24 president's approval before doing so. For the most part, members use
25 the SHB credit card when they are traveling.

26 The SHB farms approximately 30,000 acres of land. The SHB has

1 appointed eight managers to oversee the various parts of the
2 operation. Each member works to the extent he's able; typically, at a
3 job that interests him. Children perform age-appropriate tasks.
4 Members are expected to be self-motivated. Each works until he's
5 completed his responsibilities for that day. When a member becomes
6 sick, he stays home. He doesn't need to ask anyone's permission to
7 miss work; although, if he has pressing responsibilities, he would
8 notify his manager so the work is performed.

9 The SHB hires nonmembers to perform a limited number of jobs
10 within the colony. Some of the jobs that are performed by nonmembers
11 are short-term jobs. For example, the SHB pays an employment agency
12 to provide seasonal workers. By contrast, some of the jobs that are
13 performed by nonmembers are long-term jobs. For example, the SHB
14 hires four nonmember school teachers to help educate its families'
15 children. Not only does the SHB pay wages to its long-term, nonmember
16 employees, but also the SHB makes contributions to government-mandated
17 benefit programs such as the State of Washington's Industrial
18 Insurance Act.

19 The SHB does not pay wages to its members; but it does take care
20 of their needs. By way of illustration only, the SHB provides each
21 family with a residence in the colony. The residences are like
22 "condos." Furthermore, the SHB feeds its members. They typically
23 share meals together in the colony's dining hall. Finally, the SHB
24 pays for the medical care its members need. It is medical care and
25 meals that lie at the heart of this action. SHB president John Stahl
26 and the IRS disagree with respect to whether the value of those items

1 is deductible. Their disagreement has its genesis in 26 U.S.C. §
2 501(d).

3 Section 501(d) creates an exemption from federal income tax for
4 "[r]eligious . . . corporations . . . [that] . . . have a common
5 treasury[.]" The reason for the exemption is this:

6 Without § 501(d), the income of a religious corporation such
7 as the [SHB] would be subject to the regular corporate
8 income tax at the corporate level, and, if distributed to
9 organization members, the individual income tax at the
10 shareholder level. If the corporate income were not
distributed, the corporation would pay both the corporate
income tax and the accumulated earnings tax.

11 *Kleinsasser v. United States*, 707 F.2d 1024, 1025-26 (9th Cir.1983).
12 Congress decided it was unfair to require both a § 501(d) corporation
13 and its members to pay federal income taxes. *Id.* at 1026.
14 Consequently, Congress eliminated the corporate level of taxation and
15 left "a single tier of individual income taxation. *Id.*

16 An individual member's federal income tax liability is determined
17 by application of partnership accounting principles. *Kleinsasser*, 707
18 F.2d at 1026. The § 501(d) corporation files a partnership tax
19 return. *Id.* at 1025 (citing Treas. Reg. (26 C.F.R.) § 1.6033-2(e)).
20 "The partnership tax return allows the Internal Revenue Service to
21 determine how much income must be reported by organization members."
22 *Id.* at 1026. Each member files an individual tax return in which he
23 declares his pro rata share of the corporation's income as his
24 personal gross income. 26 U.S.C. § 501(d). For tax purposes, each
25 member's share is treated as though it were a dividend received. *Id.*
26 Individual members "pay income tax on their pro rata shares of

1 organization income." *Kleinsasser*, 707 F.2d at 1025.

2 Given the structure of § 501(d), Mr. Stahl must calculate the
3 SHB's taxable income before he can determine the amount of federal
4 income tax he must pay. Corporate deductions play an important role
5 in the process. A corporate deduction reduces the SHB's taxable
6 income. This means the SHB reports less income on its tax return.
7 The benefit to Mr. Stahl is obvious. His personal gross income is his
8 pro rata share of the SHB's taxable income. As the SHB's annual
9 taxable income goes down, so does his individual gross income. Once
10 he has calculated his gross income, he can begin looking for
11 deductions to which he, as an individual, is entitled.

12 Mr. Stahl seeks to invoke two deductions: one at the corporate
13 level; the other at the individual member level. At the corporate
14 level, the issue is whether the SHB may deduct, as business expenses,
15 the value of meals and medical care it furnished to Mr. Stahl during
16 tax years 1997, 1998, and 1999. 26 U.S.C. § 162(a) ("[t]here shall be
17 allowed as a deduction all the ordinary and necessary expenses paid or
18 incurred during the taxable year in carrying on any trade or
19 business"). At the individual level, the issue is whether Mr. Stahl
20 may deduct from his gross income the value of meals he received from
21 the SHB on its premises for its convenience during tax years 1997,
22 1998, and 1999. 26 U.S.C. § 119(a) ("[t]here shall be excluded from
23 gross income of an employee the value of any meals . . . furnished to
24 him . . . by . . . his employer for the convenience of the employer, but
25 only if . . . the meals are furnished on the business premises of the
26 employer"). Mr. Stahl bears the burden of proving he is correct with

1 respect to both deductions. See *Smith v. Comm'r of Internal Revenue*,
2 300 F.3d 1023, 1029 (9th Cir.2002) ("In general, an income tax
3 deduction is a matter of legislative grace and . . . the burden of
4 clearly showing the right to the claimed deduction is on the
5 taxpayer.'" ((alterations in the original) (quoting *Interstate*
6 *Transit Lines v. Comm'r*, 319 U.S. 590, 593, 63 S.Ct. 1279, 87 L.Ed.
7 1607 (1943))). The IRS argues Mr. Stahl cannot satisfy his burden of
8 proof.

9 The parties have filed cross motions for summary judgment.
10 "[J]udgment . . . should be rendered if the pleadings, the discovery
11 and disclosure materials on file, and any affidavits show that there
12 is no genuine issue as to any material fact and that the movant is
13 entitled to a judgment as a matter of law." Fed.R.Civ.P. 56(c). In
14 order for Mr. Stahl to defeat the United States' motion for summary
15 judgment, he must present evidence from which a rational fact-finder
16 could conclude the SHB is entitled to the corporate deduction (§
17 162(a)) and he's entitled to the individual deduction (§ 119(a)). See
18 *Nissan Fire & Marine Ins. Co., Ltd. v. Fritz Companies, Inc.*, 210 F.3d
19 1099, 1103 (9th Cir.2000). In order for Mr. Stahl to prevail upon his
20 motion for summary judgment, he must demonstrate a rational fact-
21 finder would be compelled to accept his position with respect to one
22 or both of the deductions at issue here. See *Soremekun v. Thrifty*
23 *Payless, Inc.*, 509 F.3d 978, 984 (9th Cir.2007).

24 **C.**

25 Mr. Stahl contends he may deduct from his gross income the value
26 of meals he receives on the SHB's premises for the SHB's convenience.

1 26 U.S.C. § 119(a). "The value of meals furnished to an employee by
2 his employer shall be excluded from the employee's gross income if two
3 tests are met: (i) The meals are furnished on the business premises
4 of the employer, and (ii) the meals are furnished for the convenience
5 of the employer." Treas. Reg. (26 C.F.R.) § 1.119-1(a). The IRS
6 objects to Mr. Stahl's effort to invoke § 119(a). In its opinion, Mr.
7 Stahl is not an employee of the SHB. If the IRS is correct, he is not
8 entitled to take the deduction.

9 The first step is to identify the test for determining when a
10 member of a § 501(d) corporation is also an employee of the
11 corporation. The Ninth Circuit has not addressed that specific issue.
12 Nor has any other circuit court of appeals. Some guidance may be
13 drawn from *Israelite House of David v. United States*, 58 F. Supp. 862
14 (W.D. Mich. 1945). There, a district court applied a "right to
15 control test" in a case that is similar to this one in important
16 respects. *Id.* at 862. The Ninth Circuit has used much the same test
17 in tax cases, although none involved § 501(d). *See, e.g.,*
18 *Professional & Executive Leasing v. Commissioner*, 862 F.2d 751, 753
19 (9th Cir.1988); *General Investment Corp. v. United States*, 823 F.2d
20 337, 341 (9th Cir.1987). In *General Investment Corp.*, the Ninth
21 Circuit observed the basic test is whether the employer has the right
22 to control the manner in which work is performed. 823 F.2d at 341.
23 However, the Ninth Circuit listed other factors that profitably may be
24 considered:

25 (1) whether the business has the right to discharge the
26 worker; (2) whether the business furnishes tools to the
person rendering the service; (3) whether the business

1 provides the worker with a place to work; and (4) whether
2 the work is performed in the course of the individual's
business rather than in some ancillary capacity.

3 *Id.* at 342 (citations omitted). The list in *Professional & Executive*
4 *Leasing* is virtually the same. The only factor it adds is whether the
5 purported employer withholds "taxes, workmen's compensation and
6 unemployment insurance funds[.]" *Professional & Executive Leasing*,
7 862 F.3d at 753.

8 Viewed from a distance, the relationship between the SHB and its
9 members resembles that of employer and employee. The SHB has the
10 authority to determine which job a member will perform and how he will
11 perform it. The SHB provides its members with places to work and the
12 tools they need to perform their jobs; and the relationship between
13 the SHB and its members is a permanent relationship, although the
14 members have the authority to expel a wayward brother or sister.
15 Thus, Mr. Stahl can argue plausibly he is an employee of the SHB.
16 However, upon closer examination, it is clear his relationship to the
17 SHB is very different from the typical employee/employer relationship.

18 An employer hires an employee to perform some job that will
19 benefit the employer. The employee's value lies principally in what
20 he can do for his employer. An employee can be replaced when it suits
21 his employer's interests. Not so a member of the SHB. He is part of
22 a body of believers. No member of the SHB has the authority to say to
23 another member, "I don't need you anymore. Be gone." Such statements
24 are unthinkable. Rather, the members of the SHB are distinguished by
25 their devotion to one another.

26 At the same time, the SHB is a disciplined body. Members elect

1 leaders and agree to submit to their leaders' authority, much of which
2 is vested in the office of the president. For example, he may correct
3 a member who is failing to perform his job. In theory, the president
4 could remove the delinquent member from his job and ask him to perform
5 some other job. However, the SHB would not expel a delinquent member
6 from the colony because he performed a job incompetently. Only the
7 member who breaks faith with his fellow members will be expelled.

8 The faith-based nature of the relationship between the SHB and
9 its members is further reflected by the absence of wages. Employees
10 work to earn wages, and the wages they receive are their own property.
11 The members of the SHB work, and they work hard, but they neither
12 expect to receive, nor do they receive, wages for their efforts.
13 Instead, they hold all property in common and use it to provide for
14 each other's needs. Unlike employees, they are not rewarded based
15 upon skill, or productivity, or rank. To the contrary, each receives
16 according to his needs. These are met by the colony. The SHB does
17 not look to the government for support for its members. As a matter
18 of religious principle, Hutterites refuse to participate in either the
19 Social Security system or any other government-benefit program.

20 If any doubt remains regarding Mr. Stahl's status, it is removed
21 by comparing it to the status of the nonmembers who work at the
22 colony. They bear all the characteristics of true employees. The SHB
23 hires each one to perform a specific task. It controls the manner in
24 which he performs the task. It pays him wages for the work he
25 performs, and it makes contributions on his behalf to government-
26 mandated benefit programs. His relationship with the SHB lasts only

1 as long the SHB needs his services and he performs his job to the
2 satisfaction of the SHB.

3 In conclusion, the SHB knows how to hire employees when it needs
4 them. Mr. Stahl's relationship to the SHB is substantially different
5 from that of its nonmember employees. His relationship is based upon
6 shared religious commitments, not upon job performance. Thus, were he
7 totally disabled in an accident, his relationship with the SHB would
8 continue indefinitely despite his inability to contribute materially
9 to the life of the SHB. He would not seek assistance from the
10 government, but would be supported by his fellow members. In view of
11 the preceding circumstances, a rational fact-finder would be unable to
12 determine Mr. Stahl is an employee of the SHB. This means he, as an
13 individual member of the SHB, may not deduct from his gross income the
14 value of meals he received on the SHB's premises for the SHB's
15 convenience during tax years 1997, 1998, and 1999. The United States
16 is entitled to summary judgment with respect to Mr. Stahl's claim for
17 a deduction under 26 U.S.C. § 119(a).

18 **D.**

19 Mr. Stahl contends the SHB may deduct from its gross income the
20 value of medical care and food it provided to him during tax years
21 1997, 1998, and 1999. The IRS disagrees. In its opinion, he is
22 seeking a deduction for personal, living, or family expenses. The IRS
23 argues such expenses are not deductible. 26 U.S.C. § 262(a) ("Except
24 as otherwise expressly provided in this chapter, no deduction shall be
25 allowed for personal, living, or family expenses.").

26 The parties' dispute over the deductibility of medical care may

1 be resolved quickly. Mr. Stahl acknowledges the SHB is entitled to
2 the deduction only if he is its employee. *Waterfall Farms, Inc. v.*
3 *Comm'r*, 86 T.C. 648, 2003 WL 22838540, at *7 (2003) ("When payments
4 for medical care are properly excludable from an employee's income
5 because they are made under a 'plan for employees,' they are
6 deductible by the employer as ordinary and necessary business expenses
7 under section 162(a)." (quoting Treas. Reg. (26 C.F.R.) § 1.162-
8 10(a))). As explained above, Mr. Stahl is not an employee of the SHB.
9 Thus, the corporation may not deduct the cost of his medical care
10 under § 162(a).

11 The parties' dispute over the existence of a § 162(a) deduction
12 for the cost of food is more difficult to resolve. Mr. Stahl relies
13 upon *Harrison v. Commissioner*, 41 T.C. 1384 (1981). There, a judge
14 allowed a company to deduct, as a business expense, the cost of food
15 it provided to seasonal employees. The judge found that the company
16 needed to furnish meals to seasonal employees in order to induce them
17 to work on the company's farm. *Id.* He decided that the company's
18 expenditures for employee meals were "'appropriate and helpful'" to
19 the operation of the farm. *Id.* (quoting *Welch v. Helvering*, 290 U.S.
20 111, 115, 54 S.Ct. 8, 78 L.Ed. 212 (1933)). Consequently, he ruled
21 that the company was entitled to deduct the cost of groceries as a
22 business expense. *Id.*

23 This case is distinguishable from *Harrison*. In this case (unlike
24 *Harrison*), the issue is whether a § 501(d) corporation may deduct the
25 cost of meals it provides to a member who is not one of its employees.
26 *Harrison* does not address that issue. As a result, *Harrison* does not

1 help Mr. Stahl. He must seek some other rationale for the § 162(a)
2 deduction he is attempting to invoke.

3 Mr. Stahl attempts to bolster his position by drawing upon the
4 concept of "unrelated business taxable income."² That he should rely
5 upon the concept is surprising; for it is associated with
6 organizations which are exempt from income tax pursuant to 26 U.S.C. §
7 501(c)(3). A § 501(c)(3) organization "must pay tax on income that it
8 earns by carrying on a business not 'substantially related' to the
9 purposes for which the organization has received its exemption from
10 federal taxation." *United States v. American College of Physicians*,
11 475 U.S. 834, 835, 106 S.Ct. 1591, 89 L.Ed.2d 841 (1986). The
12 preceding case is instructive. The American College of Physicians
13 ("ACP") publishes a journal named "The Annals of Internal Medicine."
14 475 U.S. at 836, 106 S.Ct. 1591. At one time, the ACP sold
15 advertising space in the journal. The advertisements typically
16 involved "pharmaceuticals, medical supplies, and equipment useful in
17 the practice of internal medicine, as well as notices of positions
18 available in that field." *Id.* The advertisements generated income
19 for the ACP. *Id.* It paid tax on the net income and filed a claim for
20 a refund, which the IRS denied. The ACP filed an action in the United
21 States Claims Court. *Id.* at 837, 106 S.Ct. 1591. The latter rejected
22 the ACP's request for a refund because it found the ACP's editorial
23 policy concerning advertising was driven by financial considerations

24
25 ²He has submitted a copy of a private letter ruling that
26 applied the concept to the agricultural operations of a
monastery. The monastery was not a § 501(d) organization; it had
been granted a tax exemption under 26 U.S.C. § 501(c)(3).

1 rather than by educational considerations. *Id.* at 849, 106 S.Ct.
2 1591. "'Those companies willing to pay for advertising space got it;
3 others did not.'" *Id.* (quoting *American College of Physicians v.*
4 *United States*, 3 Cl. Ct. 531, 534 (1983)). The Supreme Court agreed
5 the advertising in question was not substantially related to the ACP's
6 educational purpose. *Id.* at 849-150, 106 S.Ct. 1591. Consequently,
7 it upheld the Claims Court's decision to deny a refund.

8 Unlike the American College of Physicians, the SHB is not a §
9 501(c)(3) organization. It is a § 501(d) organization. Thus, the SHB
10 does not have to worry about unrelated business taxable income:

11 [A § 501(d)] organization is granted its exemption not
12 because of function, but because of form. It is totally
13 unrestricted in function. Indeed, § 501(d) specifically
14 allows the organizations it exempts to engage in business
15 and thus compete with nonexempt entities. The only
16 requirements for the exemption are that there be a common
17 treasury, that the members of the organization include pro
18 rata shares of organization income when reporting taxable
19 income and, implicitly, that the organization have a
20 religious or apostolic character. Once this requirement of
21 form is fulfilled, the exempt organization is unlimited as
22 to function. It can farm, as the Milford Colony does, or
engage in manufacturing, or any other business or
combination of businesses. It is definitionally impossible
for a § 501(d) organization to have unrelated trade or
business income. If the organization had income that it
failed to allocate to its members, it would simply lose its
exemption altogether.

23 *Kleinsasser*, 707 F.2d at 1029. Given the preceding observations, it
24 is clear the SHB cannot have unrelated business taxable income. Mr.

1 Stahl's reliance upon the concept is misplaced.³ Since he has no
2 other arguments to support his position, all that remains is to sum
3 up.

4 This section began with Mr. Stahl's contention the SHB may deduct
5 from its gross income, as business expenses, the value of medical care
6 and food it provided to him during tax years 1997, 1998, and 1999.
7 The IRS denies the SHB may take § 162(a) deductions for the cost of
8 medical care and meals it provided to Mr. Stahl. The IRS argues §
9 162(a) is trumped by § 262(a), which prohibits deductions for
10 personal, living, or family expenses. It is unnecessary to determine
11 whether the IRS is correct. If a § 501(d) organization is entitled to
12 take a § 162(a) deduction for food and medical care it provides to its
13 members (and its far from clear whether such a deduction is ever
14 available), the § 501(d) organization may take the deduction only if,
15 at a minimum, the member is an employee of the organization. Mr.
16 Stahl is not an employee of the SHB. Consequently, the United States
17 is entitled to summary judgment with respect to Mr. Stahl's contention
18 the SHB may deduct from its gross income the value of medical care and
19 food it provided to him during tax years 1997, 1998, and 1999.

20 **IT IS HEREBY ORDERED:**

21 1. The plaintiff's motion for summary judgment (**Ct. Rec. 15**) is
22 **denied.**

23 2. The defendant's motion for summary judgment (**Ct. Rec. 10**) is
24 **granted.**

25 _____
26 ³As a result, the Court need not consider the private letter
ruling he cites.

IT IS SO ORDERED. The District Court Executive is hereby directed to file this order, enter judgment accordingly, furnish copies to counsel, and close the case.

DATED this _____ day of November, 2009.

ORDER - 16